REPORT

DATE. July 6, 2006

TO· Administration Committee and Regional Council

FROM. Wayne Moore, Chief Financial Officer, W
213-236-1804, email: moore@scag.ca.gov

SUBJECT: Financial Statement Management Letter

EXECUTIVE DIRECTOR'S APPROVAL:

RECOMMENDED ACTION:
Receive and File

SUMMARY:
Receive and file the attached letter from KPMG LLP that discusses findings made during preparation of SCAG's 2005 Comprehensive Financial Report.

BACKGROUND:
During the audit of SCAG's 2005 financial statements, KPMG LLP, external auditors for SCAG since 2000, required the restatement of the governmental activities' net assets and the fund balance of the General Fund as of June 30, 2004. Their finding that weaknesses exist in SCAG's internal control procedures are stated in their letter. SCAG management was fully aware of and proactively resolved the restatement issues. Based on these actions and the minimal financial impact of the restatements on the agency's financial position, management does not agree with this finding.

FISCAL IMPACT:
There is no fiscal impact associated with this report.

KPMG LLP
Suite 2000
355 South Grand Avenue
Los Angeles, CA 90071-1568

April 17, 2006

The Honorable Members of the Regional Council
Southern California Association of Governments

Ladies and Gentlemen:

We have audited the financial statements of the Southern California Association of Governments (SCAG) for the period ended June 30, 2005, and have issued our report thereon dated April 17, 2006. In planning and performing our audit of the financial statements of the Southern California Association of Governments, we considered internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. An audit does not include examining the effectiveness of internal control and does not provide assurance on internal control.

The maintenance of adequate internal control designed to fulfill control objectives is the responsibility of management. Because of inherent limitations in internal control, errors or fraud may nevertheless occur and not be detected. Also, controls found to be functioning at a point in time may later be found deficient because of the performance of those responsible for applying them, and there can be no assurance that controls currently in existence will prove to be adequate in the future as changes take place in the organization.

However, we noted certain matters involving internal control and its operation that we consider to be a reportable condition under standards established by the American Institute of Certified Public Accountants. Reportable conditions are matters coming to our attention that, in our judgment, relate to significant deficiencies in the design or operation of internal control and could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Our consideration of internal control would not necessarily disclose all matters in internal control that might be reportable conditions.

A material weakness is a reportable condition in which the design or operation of one or more internal control components does not reduce to a relatively low level the risk that errors or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted the following matters involving internal control and its operation that we consider to be a material weakness.

Financial Reporting

Finding

One of the strongest procedures for verifying the accuracy of any set of financial statements is the periodic analysis of account balances and disclosures to ascertain the following:

- Are there unusual reconciling items to the financial statement totals which suggest the need for adjustment?
- Do the financial statement disclosures accurately reflect the accounting policies and financial activities for the year?

During the course of the audit, we noted that improvements can be made to SCAG's internal controls over financial reporting including internal analysis of account balances and financial statement disclosures.

During the current year audit, we noted that the fund balance of the General Fund at June 30, 2004 had to be restated. SCAG had previously recorded a liability in the General Fund for compensated absences that were not considered due and payable at year end. Such liability should not have been recorded in the General Fund as none of the liability was considered matured based on the guidelines of GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*. SCAG had also incorrectly recorded deferred credits associated with tenant improvement allowances provided for in certain leases. A balance of such deferred credit remained recorded in the General Fund at June 30, 2004. Finally, SCAG had previously recorded rental expenditures related to an operating lease on a straight-line basis over the life of the lease, resulting in the recording of deferred credits for the amount that the straight-line expenditures exceeded cash payments. However, in the General Fund, rent expenditures and any related payables should be recorded to the extent that rent amounts are payable with expendable available resources. As such, the aforementioned deferred credits should be removed from the balance sheet. The impact of the restatement items resulted in a $1.9 million increase in the General Fund's balance at June 30, 2004.

Additionally, we noted that the net assets of the governmental activities at June 30, 2004 also had to be restated. In previous years, SCAG had not been amortizing a deferred credit associated with a tenant improvement allowance provided for in a 1989 lease agreement. The deferred credit should have been amortized over the life of the lease, and there should have been no remaining balance at June 30, 2004. SCAG had also not been depreciating the tenant improvements associated with the 1998 lease included in capital assets. The tenant improvements recorded by SCAG should be depreciated in the governmentwide financial statements over the term of the lease. Finally, SCAG had not been recording or disclosing the net pension obligation related to its PARS Supplementary Retirement Plan. The annual pension costs should have included the annual required contributions established by the actuary, one year's interest on the net pension obligation, and an adjustment to annual required contribution. The impact of the restatement items resulted in a net decrease of $163,095 in SCAG's governmental net assets at June 30, 2004.

Recommendation

We recommend that the internal controls over financial reporting be strengthened to ensure that SCAG financial statement and disclosures are analyzed annually by management for accuracy and completeness in accordance with U.S. generally accepted accounting principles and SCAG's accounting policies.

Management's Response

While management concurs with the recommendations offered by KPMG to strengthen the annual analysis of financial statement transactions and disclosures, we also believe the auditor's role is also essential to the quality of financial reporting. The Government Finance Officer's Association (GFOA) Recommended Practices for Audit Committees states that independent auditors should objectively assess the government's financial reporting practices through their own independent review. KPMG was first contracted as SCAG's external auditors in 2000 and again in 2003. Their audit work plan under their 2003 contract included a list of audit concerns that KPMG would emphasize during the audit process. That list of concerns included:

- Matters of compliance with GASB statements and interpretations;
- Proper accounting for grants and deferred revenue; and
- Proper recording of outstanding obligations.

KPMG was contractually obligated to emphasize these areas of concern in their audit work and all of the restatements in the FY05 CAFR are related to one or more of these areas of material emphasis.

In 2003, management wanted to conform the annual audit report to Comprehensive Annual Financial Report (CAFR) standards established by GFOA. We submitted our 2003 and 2004 CAFR's to the GFOA to receive a critical review of our financial reporting, highlight any deficiencies and become eligible to receive the "GFOA Certificate of Achievement in Financial Reporting". We received valuable comments and suggestions from GFOA, and were awarded the Certificate of Achievement after the publication of our FY04 CAFR. As a consequence of comments and suggestions received from GFOA, SCAG initiated a review of compensated absences during the FY05 annual audit. It was only after this SCAG initiated review that KPMG reviewed the treatment of compensated absences as well as deferred credits and pension benefits. For these reasons and our assessment of the net financial impact of the restatements, we do not agree that the items in question were material weaknesses. SCAG was fully aware of all the items that were reclassified.

KPMG states in their finding that the impact of restatement items resulted in a $1.9 million increase in the General Fund balance on the 2004 financial statement. The General Fund is a Governmental Fund and the financial reporting of liabilities and deferred credits are only reported in the General Fund if they are expected to be payable with current available and expendable resources. Because certain liabilities and deferred credits are expected to be paid in the future they have been eliminated from the General Fund. The impact of eliminating liabilities in the General Fund is to increase the fund balance. The restatement did not create new resources; it only increased the resources reported to be available to pay only current obligations, not all obligations.

The elimination of these liabilities in our Governmental Fund financial reports does not eliminate them, it only changes how and where they are reported. These particular liabilities and deferred credits are actually included and reported in our Government-wide financial reports. The Statement of Net Assets includes all liabilities, regardless of when they may be payable. This is more consistent with financial reporting encountered in the private sector. The 2001 edition of Governmental Accounting, Auditing, and Financial Reporting (GAAFR) states "The minimum combination of 1) fund-based financial statements, 2) government-wide financial statements, and 3) accompanying note disclosures" are needed for the fair representation of a government's finances. We believe that a fair representation of SCAG's finances is available from an examination of Government-wide and Governmental fund financial statements, and the

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accompanying note disclosures. In FY05 our Net Assets decreased by $163,000 from the prior year, which is far more representative of the financial condition of SCAG, then to focus only on a restatement of $1.9 million in the General Fund. Such a narrow focus could cause an erroneous judgment of our financial condition. It is essential to give broader attention and consideration to the SCAG financial statements taken as a whole.

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These conditions were considered in determining the nature, timing, and extent of the audit tests applied in our audit of the 2005 financial statements, and this report does not affect our report on these financial statements dated April 17, 2006. We have not considered internal control since the date of our report.

This report is intended solely for the information and use of the audit committee, Honorable Members of the Regional Council, management, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties.

Very truly yours,

KPMG LLP